D.T.E. 03-47-A

Petition of Commonwealth Electric Company, Cambridge Electric Light Company, and Boston Edison Company, d/b/a NSTAR Electric, and NSTAR Gas Company, for approval of tariffs to provide recovery for costs associated with their obligations to provide employees pension benefits and post-retirement benefits other than pensions.

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I. INTRODUCTION

On April 16, 2003, Boston Edison Company ("BECo"), Commonwealth Electric Company ("ComElectric"), Cambridge Electric Light Company ("CELCo"), and NSTAR Gas Company (collectively, "Companies") filed with the Department of Telecommunications and Energy ("Department") tariffs that establish an annual adjustment factor to recover costs associated with the Companies' pension and post-retirement benefits other than pensions ("PBOP") obligations that are not currently being collected in base rates. That factor would apply to each of the four companies. The Companies state that their proposal is intended to implement the accounting treatment approved by the Department in Boston Edison Company/Commonwealth Electric Company/Cambridge Electric Light Company/ NSTAR Gas Company, D.T.E. 02-78 (2002). The Department docketed this matter as D.T.E. 03-47.

II. PROCEDURAL HISTORY

On May 20, 2003, pursuant to notice duly issued, the Department conducted a public hearing.[1] The Attorney General of the Commonwealth ("Attorney General") intervened pursuant to G.L. c. 12, § 11E. The Department also granted limited participant status to Fitchburg Gas and Electric Light Company, Keyspan Energy Delivery New England, Massachusetts Electric Company, Western Massachusetts Electric Company, and Associated Industries of Massachusetts.

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1 The Companies' tariffs list May 1, 2003 as the effective date. On April 23, 2003, the Department suspended the tariffs until August 1, 2003. On June 13, 2003, the Department further suspended the tariffs until October 1, 2003. On September 30, 2003, the Department further suspended the tariffs until November 1, 2003.

On June 5, 2003, the Attorney General filed a motion to dismiss the Companies' proposal ("Motion"). The Attorney General also requested that the Department stay the proceedings until the Department acted upon his motion ("Motion to Stay"). On August 7, 2003, the Department issued an Interlocutory Order denying the Attorney General's Motion and Motion to Stay. D.T.E. 03-47, at 12.

On August 6 and 7, 2003, the Department held evidentiary hearings. In support of their proposal, the Companies sponsored the testimony of James J. Judge, senior vice president, treasurer and chief financial officer of the Companies and their parent NSTAR, Inc. ("NSTAR") and Robert Spear, partner of Pricewaterhouse Coopers ("PwC"). The Attorney General sponsored the testimony of David Effron, principal of Berkshire Consulting Services. The evidentiary record includes 150 exhibits and four responses to record requests. The Companies and the Attorney General submitted briefs on August 19, 2003 ("Companies Brief" and "Attorney General Brief," respectively) and submitted reply briefs on August 28, 2003 ("Companies Reply Brief" and "Attorney General Reply Brief," respectively).

III. BACKGROUND

A. Introduction

A disjunction or incongruity amongst accounting standards and tax law as they relate to pension questions and ratemaking principles and practices is the crux of the problem before us. Previous Department attempts to resolve this incongruity have not succeeded. Thus the problem persists and becomes more acute. Economic events force a resolution. To understand why some background is necessary.

B. Financial Accounting Standards

In December 1982, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 71 ("SFAS 71"), effective 1983, which established standards for accounting for the effects of certain types of regulation. SFAS 71 sets forth the specific criteria that must be met for a regulated company to establish a regulatory asset.[2]

In December 1985, the FASB issued Statement of Financial Accounting Standards No. 87 ("SFAS 87"), effective 1987, which established new accounting standards that significantly changed the manner in which companies account for their obligations relating to employee pensions. In December 1990, the FASB issued Statement of Financial Accounting Standards No. 106 ("SFAS 106"), effective 1993, which established similar accounting standards relating to post-retirement benefits other than pensions ("PBOP").[3]

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[2] A regulatory asset is an incurred cost for which a regulatory agency such as the Department allows a regulated company to record a deferral to be considered for recovery in the future. Recognition of a regulatory asset, preserved for later decision as to future recovery, is a common feature of utility regulation at both state and federal level. As concerns utility pension and PBOP in particular, the Federal Energy Regulatory Commission and, for example, the regulatory agencies of a number of states include prepaid pensions in rate base at the full cost of capital. We cite these instances from other jurisdictions to show the unexceptional nature of the issues before us. Cities of Greenwood and Seneca, SC v. Duke Power Company, 77 F.E.R.C. ¶ 63,017, at item 14 (Initial Decision) (1996).

[3] We take administrative notice of the texts of SFAS 87 and SFAS 106 and of SFAS 71, another FASB rule central to the matter sub judice. See FASB website: http://www.fasb.org/pdf/fas71.pdf; http://www.fasb.org/pdf/fas87.pdf; http://www.fasb.org/pdf/fas106.pdf.

C. Summary of Accounting, Tax, and Ratemaking Treatment from 1990-2002

Prior to the issuance of SFAS 87, the Department's accounting treatment for pension expense varied by company. See, e.g., Western Massachusetts Electric Company, D.P.U. 85-270, at 187-188 (1986) (pension expense based on most recent actuarial report); Haverhill Gas Company, D.P.U. 155, at 20-22 (1980) (pension expense based on contribution to a company-sponsored trust). The Department allowed most companies to account for their PBOP obligations on a "pay as you go" basis. This approach allowed the companies to charge PBOP costs to expense only when benefits were, in fact, paid out to or for the benefit of retirees. See Massachusetts Electric Company, D.P.U. 92-78, at 83 (1992); Bay State Gas Company, D.P.U. 89-81, at 29 (1989). Thus, the service benefits enjoyed by one generation of ratepayers from the work performed to serve them by a contemporary generation of utility workers were, in no small part, to be paid for by a future generation of ratepayers, who would bear the costs (on a pay as you go basis) of pension obligations accrued to fund the retirement trust of that earlier generation of utility workers.

Through the issuance of SFAS 87 and SFAS 106, FASB established a systematic method for all companies to recognize employees' future retirement benefit costs as they accrue over each employee's service life.[4] Although FASB dictates the accounting treatment

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[4] Under these standards, the pension/PBOP obligations that accrue over the working life of each employee are offset by the earnings on the trust funds that are set aside specifically to provide the funding of those benefits (Exh. NSTAR-JJJ at 11). The trust res, comprising, as it typically does, a variety of investments for the benefit of utility pensioners, is subject to market vagaries, even when managed in full compliance with (continued…)

for pension/PBOP expenses, actual contributions to the pension/PBOP plans are made pursuant to the requirements of the Employee Retirement Security Act ("ERISA"), administered by the Internal Revenue Service ("IRS"). It needs to be observed and, once observed, stressed that SFAS 87 and 106 standards and IRS/ERISA requirements are not the same, even though they relate to the same area of expense.[5] Failure to appreciate the distinction is a fruitful source of misunderstanding. Since the issuance of SFAS 87 and SFAS 106, treatment of pension and PBOP expenses for the accounting purposes may be, and usually is, different from actual contributions to pension/PBOP plans.[6]

The changes in accounting rules required the Department to reexamine how best to include a representative level of pension/PBOP expenses in base rates. See D.P.U. 89-81, at 29-35; Western Massachusetts Electric Company, D.P.U. 87-260, at 39-47 (1988). Regarding pension expense, the Department has not endorsed any specific ratemaking method

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[4](...continued)
the Prudent Man Rule expressed in ERISA § 404(a)(1), 29 U.S.C.A. § 1104(a)(1). There is, of course, no credible suggestion on this record of failure to comply with this rule or with similar rules governing fiduciary duties to trust beneficiaries.

[5] The IRS' rules allow for and limit the tax deduction of contributions to pension and PBOP plans (Exh. NSTAR-JJJ, at 12-13).

[6] Prior to the adoption of SFAS 87, pension expense was based on Accounting Principle Board Opinion No. 8, which allowed flexibility to actuarial assumptions. Therefore, pension expense and plan contributions were generally the same. The adoption of SFAS 87 made pension plan expense less flexible, so pension expense and plan contributions began to diverge (Exh. D.T.E. 1-2 [rev.], Att. at 1). For example, as shown on Exhibit DTE-1-2 [rev.], Att. at 1, pension plan cash contributions and FAS 87 pension expense have differed by as much as $78 million in 1998, $52 million in 2000, and $66 million in 2001.

and has treated the intricacies of these expenses on a case-by-case basis. See Boston Gas Company, D.P.U. 96-50 (Phase I) at 81 (1996). Typically, the Department typically uses an amount equal to the cash contribution to the pension plan as the representative level of pension expense to include in rates. See, e.g., Commonwealth Electric Company, D.P.U. 89-114/90-331/91-80 Phase One at 65-66 (1991); Western Massachusetts Electric Company, D.P.U. 88-250, at 67-72 (1989); D.P.U. 87-260, at 44-47. Regarding PBOP expense, the Department balances the competing interests of (1) SFAS 106 and (2) the need to allocate PBOP expenses appropriately and in a cost-effective manner between current and former ratepayers, as well as between ratepayers and shareholders. See, e.g., D.P.U. 96-50 (Phase I) at 81; see also Cambridge Electric Light Company, D.P.U. 92-250, at 54 (1993). Indeed, as the course of treating pension and PBOP expenses really shows, it has been difficult and gets progressively more difficult to determine representative levels of pension and PBOP expenses for inclusion in base rates and, further, to settle on a base-rate treatment method applicable both to all regulated companies and to all circumstances that may reasonably be expected to arise between rate cases. The shifting course of Department treatment is evidence of this difficulty.[7] Economic events now persuade us to consider whether and how to develop a consistent practice and treatment of these expenses henceforth, for all jurisdictional gas and electric companies.

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[7] Contemporaneous with the instant docket, the Department has before it two other cases, approaching decision. Thus, it is fair to observe that the incongruity of FASB, IRS/ERISA, and ratemaking have arisen in the electric, gas, and water utilities simultaneously. See Boston Gas Company, D.T.E. 03-40; Aquarion Water Company of Massachusetts, D.T.E. 03-91.

On November 27, 2002, the Companies stated that economic circumstances made the differences between accounting requirements of SFAS 87 and SFAS 106, the requirements of the ERISA/IRS and the Department's ratemaking policies and practice untenable. D.T.E. 02-78 (Company Filing). The Companies had requested that they be authorized by the Department to establish two assets: the first for the underfunding in the Companies' pension plan as of December 31, 2002 in the amount of $168.8 million ("Regulatory Asset"); the second, on an ongoing basis, for the difference between the amount of pension and PBOP expenses recorded under the accounting rules and the amount collected in base rates ("Pension/PBOP Deferral") (Exh. NSTAR-JJJ at 15). Specifically, the Companies stated that, absent the establishment of the Regulatory Asset, the Companies would have to take a pre-tax charge to their common equity of $434.7 million, equal to the $177.7 million[8] unfunded pension obligation plus the prepaid pension balance of $257 million (id. at 15-16).[9] In the absence of the Pension/PBOP Deferral, the Companies stated that they would suffer "large, detrimental financial impacts" due to the problems with "treating the long-term funding pension and PBOP as a 'normal' rate case expense" (id. at 28-29). The Department approved the Companies' requested accounting treatment on December 20, 2002. D.T.E. 02-78, at 1.

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8 This $177.7 million includes some non-utility or unregulated operations.

9 An after-tax charge of $264.2 million ($434.7 x 60.775 percent) would reduce the Companies' common equity by approximately 20 percent (see Exh. AG-1, at 31).

IV. DESCRIPTION OF COMPANIES' PROPOSAL

The Companies state that the proposed annual adjustment factor addresses the lack of congruity among accounting requirements of SFAS 87 and SFAS 106, the requirements of the ERISA/IRS, and the Department's ratemaking policies and practices (Exh. NSTAR-JJJ at 28). By addressing these differences, the Companies maintain, their proposal accomplishes two major objectives that are not currently satisfied through traditional base-rate treatment of pension and PBOP expenses (id.). First, the Companies' proposal would ensure that customers pay no more and no less than the amounts actually needed to provide pension and PBOP benefits to employees (id. at 28-29). Second, the Companies' proposal would ensure that the financial health of the Companies is not impaired as a result of the financial reporting and cash-flow issues that arise from the extreme volatility of pension and PBOP funding obligations (id. at 29).

The Companies state that the approval in D.T.E. 02-78 was necessary to establish the Regulatory Asset for the underfunding in their pension plan at the end of 2002, and thereby allow them to avoid a pre-tax charge to equity of approximately $435 million for 2002 (Exhs. PwC-RJS at 3; NSTAR-JJJ at 15). The Companies state that, without approval of the proposed annual adjustment factor, their auditors will require not only the charge to equity but also expensing of the pension and PBOP costs deferred during 2003 (Exh. NSTAR-JJJ at 2-3; Tr. 1 at 170).[10]

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[10] The recovery of the Pension/PBOP Deferral through the proposed annual adjustment factor will provide assurance to the Companies' auditors that the Regulatory Asset (continued...)

As to the specifics of their proposal, the Companies request that they be allowed to include in their rates an annual adjustment factor that either reconciles and recovers or else reconciles and refunds the annual amounts booked by the Companies in accordance with SFAS 87 and SFAS 106 with the annual pension and PBOP expense amount included in the Companies' base rates (Exh. NSTAR-JJJ at 30). The Companies state that the proposed annual adjustment factor is the sum of three components: (1) an average differential amount that increases the amount the Companies collect annually in rates ("Average Differential Amount"); (2) a reconciliation adjustment that either collects or refunds the difference between the amounts collected in rates and the FAS 87 and FAS 106 expenses booked by the Companies ("Reconciliation Adjustment"); and (3) carrying charges on unamortized reconciliation balances and any prepaid amounts (id. at 30).

The Companies propose the Average Differential Amount to update the annual level of pension and PBOP costs recovered through rates. The Average Differential Amount represents the difference between the expense amount of pension and PBOP expenses currently included in the Companies' base rates and the average amount of years 2001 through 2003 cash contributions made to their pension and PBOP plans (id. at 31). The Companies propose that the adjustment continue until the Companies establish a new base rate amount for pension and

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[10](…continued)
established in 2002 will ultimately be recovered in rates. Such was the essence of the testimony of PwC's Mr. Spear, "the audit partner in charge of the account for NSTAR and the four companies" (Tr. 1, at 85-86, 164-170).

PBOP expense (id.). This proposal would increase rates by $40,406,000 on January 1, 2004 (Tr. 1, at 42).

The Companies propose the Reconciliation Adjustment to collect or refund the difference between pension and PBOP costs included in the Companies' base rates and SFAS 87 and SFAS 106 expense amounts booked by the Companies (Exh. DTE 1-4 [rev.], at 1). This difference, adjusted for any previously unamortized balances, is amortized over a three-year period (Exh. NSTAR-JJJ at 31-32).[11] The Companies' Reconciliation Adjustment also reconciles forecast recovery to actual recovery. The Companies' proposal regarding the Reconciliation Adjustment would increase rates by $11,618,000 on January 1, 2004 (Tr. 1, at 44).

The Companies propose carrying charges, based upon a weighted cost of capital, to compensate for the time value of money (Exh. NSTAR-JJJ at 33). The weighted cost of capital amounts would be applied to the unamortized Reconciliation Adjustment balances (id.), and any prepaid amounts, which occur because the Companies have paid funds into the pension and PBOP plans that are greater than amounts required by SFAS 87 and SFAS 106 (id. at 34). Prepayment in greater amount follows Department direction as discussed in footnote 21, below. The Companies' proposal regarding carrying charges would increase rates by $20,733,000 (Exh. DTE 1-4 [rev.]; Tr. 1, at 44-45).

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[11] The Companies' combined unamortized balance is $ 7.9 million (Exh. DTE 1-4 [rev.], Att. at 1).

The Companies seek to implement their annual adjustment factor on January 1, 2004 and each January 1st thereafter (Exh. NSTAR-JJJ at 29). The Companies expect to file an annual adjustment factor on December 1st every year, commencing 2004 (coincident with the reconciliation filings for each of the electric companies relating to the transition charges, transmission charges, and Standard Offer and Default Service charges) (id. at 29, 36).

V. POSITIONS OF THE PARTIES

A. Attorney General

The Attorney General claims that, for more than a decade, the Department has based rate recovery on the cash that companies have actually contributed to their pension and PBOP funds averaged over several years (Attorney General Brief at 1). The Attorney General characterizes the Companies' proposal as a departure from this precedent because the Companies seek recovery of employee retirement costs equal to the booked accounting expense levels of pension and PBOPs, which vary with actuarial assumptions, interest rates, and stock market values (id.). The Attorney General notes that the Companies' complaints regarding pension and PBOP expense volatility and request to collect SFAS 87 and SFAS 106 amounts from ratepayers is not new (Attorney General Reply Brief at 2, n.2, citing D.P.U. 88-250, at 70, 72-73; Fitchburg Gas and Electric Company, D.T.E. 02-24/25, at 115 (2002)).

The Attorney General states that the Department should reject this proposed departure from precedent for four reasons (Attorney General Brief at 1; Attorney General Reply Brief at 1). First, the Attorney General notes that the Companies' proposed annual adjustment factor would result in higher costs to customers, without the Department having undertaken a comprehensive review of the Companies' costs and revenues (Attorney General Brief at 1). The Attorney General cites the situation where Boston Edison Company wrote down equity of over $200 million associated with its investment in the unregulated business undertaken with Residential Communications Network Corporation ("RCN"), yet still retained its "A" bond rating (id. at 13). The Attorney General argues that granting the Companies' proposal would adjust individual base rate cost items without considering the overall effect on NSTAR's earnings and the reasonableness of the resulting rates for customers, and so represents disfavored single-issue ratemaking (id. at 1, 5-12).[12]

Second, the Attorney General argues that the Companies have not shown that the Companies' proposal is necessary to avoid financial impairment (id. at 1, 12-13). The Attorney General specifically takes issue with the Companies' position that the Companies will face financial impairment because they would have to take a charge to common equity (Attorney General Brief at 12-13; Attorney General Reply Brief at 5). The Attorney General states that equity write-offs are not uncommon and do not necessarily lead to financial impairment to ratepayers, again citing the Companies' experience with the write-down related to RCN (Attorney General Brief at 13). The Attorney General further claims that SFAS 71, which the Companies claim requires a write-down, does not mandate that the Companies write-down equity absent Department approval of their proposal (id. at 12-13). The Attorney General reasons that because the Department has always permitted recovery of reasonable and

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12 The Attorney General states that there is no evidence that the Companies failed to earn their allowed rate of return or that current rates are too low without including recovery of the higher pension costs (Attorney General Brief at 1).

prudent pension and PBOP expense through the cost of service, there is reasonable assurance that the Department will establish rates that will recover those costs, and, accordingly, the Companies may maintain the Regulatory Asset and not have to write-down the prepaid pension assets (id. at 13).

Third, the Attorney General argues that the Companies' proposal constitutes prohibited retroactive ratemaking, violating the Department's previously ordered rate freeze (id. at 1-2, 16-18). The Attorney General states that the Companies are under a rate freeze until September 2003 (id. at 16). The Attorney General claims that, despite this rate freeze, the Companies are seeking recovery of costs incurred in 2002 and 2003 (id.). He concludes that the Department should not allow the Companies to avoid the consequences of the rate freeze by surgically deferring just one element from their cost of service and then requesting recovery for it after the rate freeze period (id. at 18).

Finally, the Attorney General makes several arguments concerning the Companies' calculation of the proposed annual adjustment factor (id. at 14-16). He claims that it would be inconsistent with Department precedent to allow carrying charges (id. at 14). He also asserts that the Companies' proposal (1) may result in a double recovery of costs; (2) bases cost adjustments on indeterminable levels of recovery from customers; (3) bases carrying charges on capital costs that are clearly outdated; and (4) does not require that any of these amounts be used for cash contributions to the trust funds (id. at 14-16).

B. Companies

The Companies state that they are proposing the annual adjustment factor to deal with the existing conflict among traditional cost-of-service ratemaking, accounting requirements, and tax requirements for the funding of pension and PBOP benefits (Companies Brief at 1-3, 5; Companies Reply Brief at 2). The Companies note that the existing conflict between accounting and ratemaking treatment of pension and PBOP expenses required the Companies to request an accounting ruling in 2002 to avoid large, detrimental financial effects (Exh. NSTAR-JJJ at 28; Companies Brief at 3). The Companies argue that their proposed annual adjustment factor is an improved ratemaking approach that will allow for the recovery of pension and PBOP expenses in an objective, standardized, fair, and workable manner (Exh. NSTAR-JJJ at 28; Companies Reply Brief at 2).

The Companies state that the Attorney General is mistaken in believing that an adjustment of base rate items may lead to an increase in the Companies' revenue and may be single issue ratemaking (Companies Reply Brief at 4-8). The Companies argue that the proposed annual adjustment factor is fully reconciling, which means that the Companies' revenues will be reduced, rather than increased, in the future (id. at 6, n.5). The Companies also claim that the Attorney General misstates the Department's stated policy disfavoring single issue ratemaking (id.).

With regard to the Attorney General's contention that the Companies may not be financially impaired, the Companies note that the Attorney General ignores the record evidence establishing that, in the absence of the proposed annual adjustment factor, the Companies and their customers will face detrimental and unnecessary financial consequences relating to an extraordinary charge against common equity due to write-down of the Regulatory Asset plus prepaid pension balance (id. at 15). The Companies list the financial consequences that would flow through to customers in the form of higher costs: (1) the downgrading of the Companies' bond ratings, (2) the impairment of the Companies' access to capital, and (3) reductions in the stock prices of the Companies' parent company (id. at 17).

The Companies claim that their proposal does not violate either the rate freeze or principles of retroactive ratemaking (id. at 21-23). The Companies argue that, like other accrued expenses, such as depreciation, the prospective level of pension and PBOP costs is appropriately based, in part, on past events (id. at 22-23).

Finally, the Companies reject several allegations by the Attorney General regarding the calculation and funding of their proposal (id. at 18-21). As examples of what the Companies characterize as the Attorney General's mistakes and erroneous statements, the Companies cite that the Attorney General's (1) assertion that the recovery of carrying charges on the net prepaid pension and PBOP balance is inconsistent with Department precedent,[13] (2) comparison

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13 The Companies point to D.T.E. 92-250, at 54, and the settlement approved in Boston Edison Company, D.P.U. 92-92 (1992) (Companies Reply Brief at 19-20). Settlements, of course, set no binding precedent.

of pre-tax carrying cost rate with the post-tax return on equity,[14] and (3) statement that the Companies will not be required to make any contributions to their pension plan (id.).[15]

VI. ANALYSIS AND FINDINGS

A. Introduction

The Department has not endorsed a specific method for the calculation of pension and PBOP expenses for ratemaking purposes but has always sought only to include an amount that allows for just and reasonable rates. See, e.g., D.P.U. 96-50 (Phase I), at 81; D.P.U. 89-81, at 33-34. Our precedent has been that the determination as to what is reasonable for each electric and gas distribution company will be conducted on a case-by-case basis.[16] See D.P.U. 96-50, at 81. There is discretion to evolve new approaches to ratesetting, however. In setting rates, the Department's scope of decision is not bound by a single method. Massachusetts Electric Company v. Department of Public Utilities, 376 Mass. 294, 302 (1978); Verizon Massachusetts, D.T.E. 01-31 (Phase II) at 72 (2003), citing American Hoechest Corporation v. Department of Public Utilities, 379 Mass. 408, 413 (1980), and New England Telephone & Telegraph Company v. Department of Public Utilities, 371 Mass. 67, 71 (1976).

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14 The Companies explain that these rates are not directly comparable since the pre-tax rate is intended to provide for recovery of income taxes associated with the return on equity (Companies Reply Brief at 18, n.8).

15 The Companies note that ERISA law, regulations and IRS rules require contributions to the pension and PBOP plans (Companies Reply Brief at 20-21).

16 See § III.C, supra.

The Companies seek approval of a fully reconciling, adjustment mechanism that functions outside of base rates, a type of mechanism that the Department has approved in the past without being challenged as inappropriate single-issue ratemaking.[17] See, e.g., Electric Fuel Charge Investigation, D.P.U. 7357 (1946) (approval of reconciling charge for cost of coal used to generate electricity); Worcester Gas Light Company, D.P.U. 11209, at 8-10 (1955) (approval of reconciling charge to cover cost of natural gas); Massachusetts Electric Company, D.P.U. 17334 (1972) (approval of purchased power cost adjustment); Massachusetts Electric Company, D.P.U. 805/808 (1981) (approval of oil conservation adjustment); D.P.U. 89-114/90-331/91-80 Phase One at 167-170 (approval of conservation adjustment); see also Consumers Organization for Fair Energy Equality v. Department of Public Utilities, 368 Mass 599, 606 (1975) (noting that reconciliation mechanisms hold particular appeal where the utility had only minimal bargaining power about the particular items of cost).

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17 Employment of reconciling mechanisms outside of base rates is hardly an innovation, but is, in fact, at least a half-century old. It typically is found useful as a way to avoid repetitive and costly general rate proceedings. Worcester Gas Light Company, D.P.U. 11209 (1955). The Companies' proposal is very similar to one of the first reconciling mechanisms approved by the Department. In Electric Fuel Charge Investigation, D.P.U. 7357 (1946), we allowed a reconciling factor for the cost of coal used to generate electricity. As with the Companies' proposal, that factor was to be added to but apart from base rates and could be positive or negative. The reconciliation of certain expense items is consistent with Massachusetts Electric Company v. Department of Public Utilities, 376 Mass at 302.

Moreover, even were the Companies' proposal to be considered single-issue ratemaking,[18] the Department may engage in generally disfavored, single-issue ratemaking, provided doing so is warranted by the exigency of the problem facing a regulated company and the importance of potential relief to that company or its customers.[19] See, e.g., Cambridge Electric Light Company, D.P.U. 490, at 2 (1982) (allowing Cambridge Electric Light Company to adjust base rates to recover increased property tax expense); Capital Recovery, D.P.U. 859, at 6 (1982) (allowing New England Telephone and Telegraph Company to adjust base rates to recover depreciation costs and expenses); cf. New England Telephone and Telegraph Company, D.P.U. 84-267, at 1, 12-14, 20 (1985) (dismissing, as inappropriate, disposition of certain limited rate increase and rate structure issues outside a general G.L. c. 159 rate case, and denying motion and stipulation so to dispose made by petitioner and other parties including the Attorney General).

Having considered our precedent regarding pension and PBOP cost recovery and our precedent regarding adjustments to a regulated company's revenues outside of a general rate cases pursuant to G.L. c. 159, § 20, and especially to G.L. c. 164, § 94, we find that the

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18 Here the Attorney General's terminology or labeling amounts to petitio principii. Adjusting a single cost element that then remains in base rates may be regarded as single-issue ratemaking, whether permissible or not. But removing a volatile element from base rates for annual reconciliation is something quite apart from and different in kind from single-issue ratemaking.

19 Here we note that in D.T.E. 02-78, at 4, the Attorney General's letter of December 12, 2002, at 4, argued in favor of examination, discovery, hearing, and briefing on a matter that he would have had us dismiss in the instant docket as an impermissible, single-issue rate case. See D.T.E. 03-47, at 3-5, Interlocutory Order (August 7, 2003).

Companies' proposal is not a departure from our precedent that must be automatically rejected. The proposal lies within the sound exercise of the Department's discretion. See, e.g., Cambridge Electric Light Company, D.P.U. 490 (1981); Capital Recovery, D.P.U. 859 (1982); Default Service, D.T.E. 02-40-B (2002). We exercise our discretion to consider the proposal. In doing so, we must first review the circumstances that precipitated the Companies' filing the proposal and then determine if a remedy is warranted.

B. Necessity of Change

The Companies' proposal is driven by the differences between the amounts the Companies collect in rates for pension expense and the expense they are required to book pursuant to SFAS 87 (Exh. NSTAR-JJJ at 2-3). Under SFAS 87, the Companies are required to compare the actuarial present value of the total cost of pension benefits[20] with the fair value of the assets of the plan. If the cost of the pension and PBOP benefits exceeds the fair value of the assets, the Companies must book an Additional Minimum Liability consisting of two components: (1) an amount equal to the unfunded amount in the pension plan; and (2) the write-down of any amounts that the Companies prepaid into the pension plan, i.e., amounts the Companies paid into the plan over and above the amount recorded as an expense pursuant to SFAS 87.

In recent years (i.e., since 1999 and up to the date of filing in this docket), the effects of a declining stock market and steeply falling interest rates have taken their toll on the value

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20 The actuarial present value of the total cost of pension benefits is referred to as the Accumulated Benefit Obligation.

of the Companies' pension and PBOP plans (id. at 14). By the end of 2002, the Companies, although prepaying their pension plan by approximately $257 million, were faced with a pre-tax Additional Minimum Liability of approximately $435 million (id. at 15).[21] The Department's accounting ruling in D.T.E. 02-78 allowed the Companies to record two assets on their books: (1) an amount equal to the underfunding in the Companies' pension plan as of December 31, 2002 (previously defined as "Regulatory Asset"); and (2) a deferral, on an ongoing basis, for the difference between the amount of pension and PBOP expense recorded under the accounting rules and the amount collected in base rates (previously defined as "Pension/PBOP Deferral").

The Companies claim that the accounting ruling in D.T.E. 02-78 does not allow them to maintain the Regulatory Asset recorded in 2002 indefinitely into the future. The Companies have explained that to maintain the Regulatory Asset, a mechanism must be in place that allows recovery of the Pension/PBOP Deferral (Tr. 1, at 121, 173-174).[22] This mechanism must

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21 The $435 million is the sum of the pension prepaid amount of $257 million plus the underfunded amount of $178 million. In making pension prepayments, we note--and it is important so to note--that the Companies have followed a course that the Department has encouraged utilities to follow. Prepayment to the maximum extent allowed by the Federal Tax Code results in savings that keep base-rate levels for pension expense significantly lower than they would be, absent prepayments. Bay State Gas Company, D.P.U. 92-111, at 226-227 (1992); D.P.U. 92-78, at 84; see also D.P.U. 92-78, at 46 citing Massachusetts Electric Company, D.P.U. 89-194/195, at 28 (1990). Where adverse consequences result from following the Department's directives or encouragement, there is a certain justice in at least hearing a claim for relief arising from such compliance and, if warranted, granting it.

22 An alternative to the proposed mechanism as an answer to SFAS 71 would be a § 94 rate case (Tr. 1, at 158) .

allow recovery of the Pension/PBOP Deferral over a reasonable time period. The Companies further explain that if no such mechanism is approved, they must write-down equity equal to the Companies' after-tax cost of both the Additional Minimum Liability plus the Pension/PBOP Deferral in 2003 (id. at 170). The Companies state, and Mr. Spear concurs, that a reasonable time period would be a three to five year period (Exh. NSTAR-JJJ at 31-32; Tr. 1, at 121, 173-174).

The Attorney General, through the testimony of his expert, Mr. David Effron, claims that it is not clear that SFAS 71 requires a three to five year period for recovery of the Pension/PBOP Deferral (Tr. 2, at 264-266). Mr. Effron states that the Department has always permitted recovery of reasonable and prudent pension and PBOP expenses through the cost of service, and so there is reasonable assurance that the Department will establish rates that are adequate to generate revenues that will recover the pension and PBOP costs (Exh. AG-2, at 9). Accordingly, Mr. Effron argues that SFAS 71 allows the Companies to maintain the Regulatory Asset to offset the Additional Minimum Liability (id.).

In D.T.E. 02-78, the Department approved the Companies' request to defer and to record as a regulatory asset or liability the difference between amounts for pension and PBOP allowed in rates and the amounts booked under SFAS 87 and 106. The Department also recognized that differential as a regulatory asset. For potential ratemaking and recovery purposes, the Department in D.T.E. 02-78 imposed no set time limit, nor was one implied. But as we noted above, there is incongruity amongst accounting, ratemaking, and tax treatment of pension and PBOP expenses. An indefiniteness as to the timing of rate recovery that the regulator finds tolerable may not, in fact, meet the requirements of FASB under SFAS 71.[23] In general, even where not specific to utilities (as SFAS 87 and SFAS 106 are) FASB accounting rules apply to all corporations (not just utilities) and require keeping their pension plans sound at all times. The long cycles of utility ratemaking for recovery of a pension-related regulatory asset do not characterize most corporate endeavors in the economy at large. SFAS 71 allows some latitude for this difference but requires that a regulator "provide reasonable assurance of the existence of an asset," including probability of recovery within a reasonable, finite period (SFAS 71 ¶ 9 ; Exh. PwC-RJS, at 2-4). Lack of timing specificity for recovery can have adverse implications under SFAS 71, ¶9(a)'s probability of recovery criterion and likely would have such implications in the matter at hand (Exh. PwC-RJS, at 3-6).

The Department cannot change the terms of SFAS 71 and its interaction with SFAS 87 and SFAS 106. The Department either must accept the consequences that FASB standards would visit upon regulated utilities' operations, and ultimately upon their customers, or must adapt regulatory practice to avert those consequences if we conclude that they can and should be averted. We have previously held that financial accounting standards do not automatically dictate ratemaking treatment, D.P.U. 92-78, at 79-80, citing Bay State Gas Company, D.P.U. 89-81-A, at 33 (1989); and that remains our principle. Consistent with that view, we nonetheless consider financial accounting standards as a factor in the ratemaking process. The

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23 When PwC's Mr. Spear testified about the interplay of SFAS 71, 87, and 106, he stated: "Again, the standard that needs to be met is, the mechanism needs to provide for the full recovery of the costs over a reasonable period of time. So if the period of recovery is open-ended, that creates a problem. It can't be open-ended. That's why we're talking about the three- to five-year period (Tr. 1, at 173-174)."

Department is charged with setting just and reasonable rates for companies within our jurisdiction and we cannot permit accounting standards alone to determine our treatment of expense. Id. at 80, citing D.P.U. 85-270, at 118-119. To the extent a potential conflict exists between financial accounting standard or SFAS and ratemaking, the Department strives to maintain an equitable balance. In the instant case, we have the clear message of SFAS 71 that a regulatory asset must be probable of recovery within, to adopt PwC's Mr. Spear's gloss of SFAS 71, "a relatively reasonable, that is, short period of time" in order to avert a write-down in the circumstances involved in this docket (Tr. 1, at 157, 164). In ordinary acceptation, the phrase "reasonable period" denotes or at least suggests something finite and certainly not "open-ended," however much opinion might vary as to how long that period may be in different enterprises and circumstances.

Moreover, Mr. Spear's gloss of SFAS 71 is something more than the standard expert testimony to be weighed in one of the customary "battles of the experts [that] are bound to be part of any ratesetting scheme." Verizon Communications, Inc. v. Federal Communications Commission, 535 U.S. 467, 522, 122 S.Ct. 1653, 1678 (2002) (Breyer, J., concurring in part and dissenting in part). Mr. Spear is the engagement partner and authorized speaking agent in this matter for PwC. PwC is the very actor that is authorized to state whether D.T.E. 02-78 satisfies SFAS 71's standard of probability of recovery in a reasonable period of time and can by expressing its opinion under SFAS 71 require a write-down.[24] Mr. Spear's testimony is

[24] In weighing the relative credibility of Messr. Spear and Effron's testimony, we note that, as he, through PwC, is an actor in this matter, Mr. Spear's testimony has (continued...)

clear on this point: the lack of timing specificity in D.T.E. 02-78, however much it may work for ratemaking, will not satisfy SFAS 71 requirements (Tr. 1, at 157, 173-174). Something more is needed, and that need can be supplied by a reconciling mechanism with recovery over a finite and specified period (id. at 167-168). The proposed period of three to five years would satisfy the auditors and avert a loss of equity with all the capitalization and operational problems thereby implied (id. at 31-35). As a result, the Department finds that a definite period of recovery must be specified to satisfy SFAS 71. Mr. Spear has observed that a definite period, indicative of probable recovery, would be three to five, but not exceeding ten, years (id. at 1, at 121, 173-174). Accordingly, we adopt the reasonable period needed to satisfy Mr. Spear's interpretation of SFAS 71 and set the recovery period at three years.

The Attorney General, however, states that even if the Companies must write-down equity, there may be no consequent harm to the Companies. In support of his position, the Attorney General cites the situation of Boston Edison Company, which wrote down equity in an amount over $200 million associated with its investment in an unregulated business (RCN) yet still retained its "A" bond rating (Exh. AG-1, at 26). Therefore, the Attorney General would have the Department reject the Companies' proposal.

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[24](...continued)
independent consequence, whereas Mr. Effron's has only such indirect consequence as our decision may lead to. When Mr. Spear offered the expert opinion that, absent recovery in a "reasonable period" of three-to-five but less than ten years (Tr. 1, at 121, 173-174), we need to be aware that, as an actor in the matter, Mr. Spear, unlike Mr. Effron, can himself bring about the very consequence he foresees as required by SFAS 71.

Regarding the Attorney General's argument concerning the consequent harm of a write-down of equity, the Department has already recognized that some write-downs pose the threat of serious financial repercussions to the utility operations, in the form of higher rates and lower quality of service to ratepayers. Boston Edison Company, D.P.U. 906, at 154-258 (1982). The $200 million RCN write-down was a one-off event. Its very uniqueness distinguishes that event from recurrent pension concerns. Here, instead, we are trying to rationalize the chronically vexed question of how to handle pension and PBOP expense going forward and the related question of how to avoid a needless harm resulting from, but not intended by, accounting rules applied in quite unusual economic circumstances of recent years. Moreover, in D.P.U. 906, at 154-258, the Department allowed Boston Edison Company to recover expenses associated with the cancelled Pilgrim II power plant because of the potential adverse affect on BECo and its ratepayers if recovery were not allowed. In this proceeding, the Department considers that the fundamental issue is the extent to which the Companies and their ratepayers would be affected by a write-down of equity. Based on the magnitude of the potential write-down in relation to the Companies' combined equity, the Department is persuaded that a write-down of this magnitude threatens severe financial consequences for the Companies, which would, if permitted to occur, translate directly into adverse effects on ratepayers through higher future rates, higher borrowing costs, and the potential for deterioration in service from a financially strapped provider (see Tr. 1, at 31-35).

The record amply establishes--and we conclude--that failure to adopt a pension and PBOP reconciling mechanism would inevitably trigger an equity write-down entailing significant and impairing, financial consequences for the Companies (Tr. 1, at 31-35; see Exh. PwC-RJS, at 6). These consequences would, we further conclude, more likely than not lead to adverse knock-on effects for their customers; and those latter effects concern us most. We have the testimony of both the Companies' CFO and the PwC engagement partner that, absent a regulatory mechanism the Companies will have to write-down regulatory assets and will experience the consequences of an extraordinary charge against common equity (Exh. PwC-RJS, at 6; Tr. 1, at 82-84). In both evidence and argument, the Companies have convincingly shown the risk of serious volatility in pension and PBOP expense. Exhibit DTE 1-2 [rev.], Att. at 6 shows the high degree of volatility in this expense category between 1996 and 2003 (see Companies Brief at 24-27; Companies Reply Brief at 16). The Companies' characterization of their prospects is unambiguously corroborated by their independent auditor, PwC's Mr. Spears (Exh. PWC-RJS, at 3-4; Tr. 1, at 147). Internal PwC memoranda support this view expressed in hearings (Exh. AG -2-6). The direct effects of a SFAS 71-required charge to equity would be a probable downgrading of the Companies' bond ratings with an increase cost of capital and resultant increase cost to finance utility activities and service to customers. A secondary effect could be to implicate the Companies' existing credit agreements. Finally, a reduction in stock price occasioned by a write-down of equity would translate into higher, future costs of equity (Exh. AG-1-58). "Investor confidence is not an insignificant element in utility regulation." Attorney General v. Department of Public Utilities, 390 Mass. 208, 229 (1983). Just as financial soundness enables good customer service, financial impairment jeopardizes that same service (Exh. AG-1-60). We are unwilling blindly to roll the dice as the Attorney General would have us do (see Attorney General Brief at 12-13). As the Supreme Judicial Court has observed, “a serious threat to the company’s financial integrity” may pose serious, if indirect, threat to its customers.” Attorney General v. Department of Public Utilities, 390 Mass at 229. Even though “many future events cannot be determined with certainty,” there is scope for the exercise of “reasonable judgment” by the Department when such a question is presented to it. Id. at 229-30. The potential consequences to customers are too great to take on the slim basis of argument and evidence the Attorney General has advanced.

Moreover, adoption of a reconciling mechanism would lead only to the equitable result that customers would pay no more than the actual costs incident to (and demanded by FASB to support) pensions and PBOP for the utility workers who provide daily service to customers year-in, year-out until retirement. Meeting that obligation to workers is the surest route to the workforce stability that is so necessary in this technical and specialized field and so essential for sound customer service.

Having found that the Companies need recovery of the Pension/PBOP Deferral within three to five years pursuant to SFAS 71, we must now consider whether the Companies’ present recovery of pension and PBOP costs is adequate. The historical approach to pension cost recovery does not establish a set date for recovery and therefore does not meet the requirements of SFAS 71 (Tr. 1, at 169-174).

Nevertheless, the Companies could still maintain the Regulatory Asset and avoid a charge to equity by promptly filing rate cases (Tr. 1, at 157-158). We note that filing a rate case could resolve the Companies' present or short-run problems but does not represent a long-term solution to the Department's chronic dilemma of setting a representative level for pension costs and resolving the incongruity amongst FASB standards, ERISA/IRS, and regulatory ratemaking. If the Companies filed standard § 94 rate cases, but no reconciling mechanism were put in place as a result of those filings, there is nothing to suggest that the circumstances present today could not continue in the future; and, given the cases we have seen since SFAS 87 and SFAS 106 were issued, there is every reason to believe the problem would recrudesce. This could create a perpetual cycle of rate cases, driven principally by the accounting rules rather than by sound ratemaking principles or customer interests.

In the absence of any action by the Department to change the historical approach to pension and PBOP recovery, and in the absence of the Companies' filing base rate cases, the Companies and, potentially, customers will face detrimental financial consequences relating to an extraordinary charge against common equity and the write-down of the Regulatory Asset and the prepaid pension amount (Exh. PwC-RJS, at 6; Tr. 1, at 82-84; Tr. 1, at 157).[25] As a result of these considerations, the Department concludes that we need to consider a new approach to pension and PBOP recovery. We now examine the Companies' proposal.

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[24] As we note at § III.C, supra, the problem has been brewing for some years and is not unique to these Companies but have appeared in the electric, gas, and water industries (n.7, supra).

C. The Companies' Proposed Annual Adjustment Factor

1. Introduction

The Companies' proposal of an annual adjustment factor consists of three components: an Average Differential Amount; a Reconciliation Adjustment; and the carrying charges on the prepaid pension and PBOP costs and unamortized pension and PBOP costs not yet recovered (Exhs. NSTAR-JJJ at 31-35; DTE-1-4 [rev.], at 1). We consider each of these in turn.

2. Average Differential Amount

The Average Differential Amount represents the difference between the expense amount of pension and PBOP expenses currently included in the Companies' base rates and the average amount of cash contributions made during 2001 through 2003 to their pension and PBOP plans (Exh. NSTAR-JJJ at 31). The Companies propose that the adjustment continue until the Companies establish a new base rate amount for pension and PBOP expense (id.). Under their proposal, the Companies would receive $110.2 million in 2004 and $99.5 million in 2005. These amounts exceed the SFAS 87 and SFAS 106 expenses, including carrying charges proposed by the Companies, by $26 million and $18 million for those respective years (see Tr. 1, at 47-50).

The Department has historically based pension cost recovery for ratemaking purposes on a utility's cash contributions to its pension plan. Prior to the Department's order in DTE 02-78, this approach provided as well as we could for reasonable pension cost recovery, since companies did not record deferrals for differences between pension and PBOP expenses pursuant to FASB rules and the amount collected in rates. In DTE 02-78, the Department authorized the Companies to recognize these deferrals. As a direct result of that action, the historical method of pension cost recovery would no longer readily serve as the basis for the recovery of pension costs, because the historical method of pension cost recovery does not meet the SFAS 71 standard that regulatory assets (deferrals) be probable of recovery within a reasonable period. That is because the recovery period of the previously deferred pension and PBOP costs is open-ended, i.e, not clearly defined as SFAS 71 requires.

Moreover, the requested $40 million increase in rates is not a factor in computing pension and PBOP reconciliation adjustment for 2004 and results in a negative deferral (i.e., overpayment) in 2005 (Tr. 1, at 54-55). In fact, the amount that would be recovered under the Companies' proposal in 2004 and 2005 would exceed pension and PBOP expenses, including carrying charges proposed by the Companies, in 2003 and 2004 respectively (id. at 48-50). For these reasons, we find that the proposed Average Differential Amount is not, strictly speaking, necessary for recovery of the Pension/PBOP Deferral.

3. Reconciliation Adjustment

The second component of the Companies' proposal, the Reconciliation Adjustment, seeks to recover pension and PBOP costs being booked by the Companies but not being recovered in base rates, adjusted for any previously unamortized balances. The adjustment proposed is derived by a three-year amortization of the difference between booked pension and PBOP costs and their pension and PBOP costs included in the Companies' rates, with the three-year[26] amortization intended to smooth even more the amount of change in the annual adjustment factor from one year to the next. Accordingly, as of January 2004, the Companies seek to include in the reconciling mechanism those pension and PBOP costs they booked in 2003 but did not collect through rates during 2003.

The evidence demonstrates that the pension and PBOP cost reconciling component is the essential element required by the Companies to maintain their Regulatory Asset and avoid the write-down to their equity (Tr. 1, at 168-171). As proposed, the Reconciliation Adjustment would collect from customers pension and PBOP expenses that the Companies incurred during the calender year 2003, adjusted for any previously unamortized balances. The Companies, however, were under a rate freeze for the first eight months or two-thirds of that year.[27] D.T.E. 99-19, at 24-25.

The Attorney General maintains that the proposed reconciling mechanism would improperly collect costs incurred during the four-year rate freeze, which ended, he asserts, September 30, 2003 (Attorney General Brief at 16-18). (In fact, the rate freeze ended four

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26 In § VI.B, supra, we chose three years as the reasonable period.

27 Under the rate freeze, the Companies were prohibited from raising distribution rates, unless exogenous factors result in cost changes. D.T.E. 99-19 at 13, 22-27. Exogenous costs were defined as changes in tax laws, in accounting principles, and in regulatory, judicial, or legislative requirements that uniquely affect the electric and gas distribution industries. Id. at 13, 25.

years after the date of the NSTAR merger, August 25, 1999, in accordance with the terms of D.T.E. 99-19).[28]

In D.T.E. 99-19, at 22-27, the Department approved a rate plan that incorporated a four-year rate freeze in the Companies' distribution rates as part of a merger of two Massachusetts business trusts that were sole owners of the Companies. As part of this rate plan that included the rate freeze, the Companies received the opportunity to apply savings achieved as a result of the business combination against merger-related costs. The Companies' Reconciliation Adjustment proposal includes recovery of pension and PBOP expenses incurred during the last eight months of the rate freeze. That is, the Companies seek to recover from ratepayers, commencing January 1, 2004, those pension and PBOP expenses that they incurred over and above what they recovered in rates during the last eight months of the rate freeze. The Companies do not seek to recover these expenses as exogenous expenses during the rate freeze.

The Companies' Reconciliation Adjustment proposal, to the extent it includes recovery of expenses over and above what it collected in rates during the rate freeze, is a request to be exempted from the restrictions of their voluntary rate freeze. Yet, the Companies do not seek this exemption by the only method permitted by D.T.E. 99-19, i.e., a claim that those additional expenses are exogenous costs. In fact, these additional expenses would not qualify as exogenous costs because the recent volatility on pension and PBOP expenses affects all

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28 That Department decision in D.T.E. 99-19 is final, having been litigated through appeal to rejection of the appellant's claims. Attorney General v. Department of Telecommunications and Energy, 438 Mass. 256 (2002).

industries, not just electric and gas utilities. D.T.E. 99-19, at 13, 25. Not being an exogenous cost, we find that the pension and PBOP expenses are the type of expenses that the Companies agreed to absorb during the rate freeze. The Department cannot permit companies to retain all potential savings realized but pick and choose the costs that will be absorbed during a rate freeze period. If the Department allowed the Companies to recover additional expenses incurred during the rate freeze, we would be allowing the Companies to contravene the intent and purpose of the rate freeze. North Attleboro Gas Company, D.P.U. 93-229 (1994) (denying regulated gas company deferral that was incurred during the time a rate freeze was in effect). Therefore, we direct the Companies to exclude the first eight months of 2003 from the Reconciliation Adjustment. Boston Edison/ComEnergy Acquisition, D.P.U. 99-19 (1999). This includes a reconciliation of forecasted and actual revenues.

4. Carrying Charges

a. Introduction

The final component of the Companies' proposal is the recovery of carrying charges (or money costs), based upon the tax-effected weighted cost of capital of each of the Companies (Exh. NSTAR-JJJ at 33-35).[29] The Companies seek to apply the weighted average cost of capital amounts to the unamortized Reconciliation Adjustment balances and any prepaid

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[29] For the electric distribution companies, BECo, CELCo, and ComElectric, the tax-effected weighted cost of capital is 10.88 percent, 12.70 percent and 13.49 percent respectively, the weighted average cost of capital allowed by the Department on the fixed component on their respective transition charges. For NSTAR Gas Company, the tax-effected weighted cost of capital is 15.53 percent, the tax-effected weighted average cost of capital allowed by the Department for NSTAR Gas' working capital component in the Cost of Gas Adjustment Clause (Exh. NSTAR-JJJ at 33).

amounts, which occur because the Companies have paid funds into the pension and PBOP plans that are greater than amounts required by SFAS 87 and SFAS 106 (id.). Further, the Companies propose to adjust the carrying charges at the time of a general rate case, when the Department sets a new weighted cost of capital (id. at 33).

b. Positions of the Parties

i. Attorney General

The Attorney General argues that the Department should reject the Companies' proposal to recover carrying charges on the net prepaid pension and PBOP balances for a variety of reasons. Initially, the Attorney General points out that the Department has generally not included prepaid pension balances related to differences between SFAS 87 pension expense and cash contributions in utility companies' rate bases. Accordingly, the Attorney General concludes that allowing the recovery of carrying charges on prepaid pension and PBOP balances would be inconsistent with the Department's precedent of disallowing the recovery of carrying charges in base rates through a return on rate base (Attorney General Brief at 14). Next, the Attorney General maintains that, based on the Companies' return on common equity in 2002, there is a strong likelihood that the Companies' present rates are adequate to provide for the recovery of carrying charges on the net pension and PBOP balances. To allow a return on those balances, reasons the Attorney General, may provide a double recovery to the Companies (Exh. AG-2, at 10). Finally, the Attorney General takes issue with the method of calculating the prepaid pension and PBOP balances upon which the carrying charges are based. The Companies' prepaid pension and PBOP balances recognize the difference between the pension costs pursuant to SFAS 87 and cash contributions to the pension plan. According to the Attorney General, the calculation of money costs should be based on the difference between pension expense recovered in rates and cash contributions to the pension plan. Accordingly, the Attorney General concludes that the Companies are not correctly measuring the money costs required by investors to cover this difference (Attorney General Brief at 14).

If the Department were to allow the Companies the recovery of carrying charges, then according to the Attorney General, the Companies' allowed return on equity should be reduced (Attorney General Brief at 10). The Attorney General notes that, since pension and PBOP costs are already included in base rates, the Companies' allowed return on equity includes compensation for this operating risk. According to the Attorney General, the Companies' proposal would shift the risk of changes in pension and PBOP costs from the shareholders to the ratepayers; and, therefore, the Companies' return on equity must be lowered in recognition of this reduced risk (id.).

ii. Companies

The Companies argue that the recovery of carrying charges on unamortized Reconciliation Deferrals and net prepaid pension and PBOP balances is appropriate. The Companies note that, because the level of expenses calculated in accordance with FASB requirements must be "realized" each year, the delay in rate recovery requires the application of carrying charges to ensure that the Companies are compensated for the time value of money (Exh. NSTAR-JJJ at 33). With respect to the net prepaid pension and PBOP balances, the Companies have made cash contributions to its pension and PBOP plans that significantly exceed the amounts that the Companies have historically booked to SFAS 87 and SFAS 106 expenses. Although these prepaid contributions will be reduced to zero as book expenses exceed cash contributions, the Companies argue that, until this is accomplished, they should be compensated for the money costs associated with these prepayments (id. at 34).

The Companies state that the Department should use our most recent determination of carrying costs as the rate for the Carrying Charges (id. at 33). For each company, this is the tax-effected weighted cost of capital (id.).

The Companies also maintain that the approval of the proposed adjustment factor will not decrease NSTAR's cost of equity. Since the Department has historically allowed the recovery of pension and PBOP costs as part of the cost of service, the Companies conclude that shareholders have not, "until very recently," anticipated any concern with respect to the recovery of these costs. Accordingly, in the Companies' view, the cost of equity would not necessarily decrease (Tr. 1, at 40).

c. Analysis and Findings

The Department must resolve the following: whether carrying charges on pension and PBOP prepayments can be recovered from customers; whether present rates to any extent provide for the recovery of these costs; the effect of the proposed adjustment factor on the Companies' cost of equity; and the cost of money rate to be used if carrying charges are permitted. We will now address each of these questions below.

The Department has generally not allowed the recovery of carrying charges on prepaid balances because of the difficulty in ascertaining whether ratepayers benefit from the prepayments. Western Massachusetts Electric Company, D.P.U. 84-25, at 59-61 (1984). The facts here are quite different, however. As an initial matter, we note that the Department has, in the past, encouraged companies to prefund pension and PBOP plans in order to take advantage of the tax-exempt status of (IRS) qualified pension and PBOP plans. D.P.U. 92-111, at 226-227. The prefunding of these plans maximizes the ability of companies to accumulate earnings on pension trust investments on a tax-free basis, thereby producing lower overall costs. Id. In addition, the poor market performance of the past several years, coupled with an extraordinary decline in interest rates, has required the Companies to make even greater contributions to fund their pension plans (Exh. NSTAR-JJJ at 16). These payments have resulted in an unusually high prepaid pension balance of $257 million, most of which has accumulated over the past six and especially the past two to four years (id. at 15; Tr. 1, at 70). Because of the benefits which inure to ratepayers from these payments and the extraordinarily high prepaid balances arising from forces at work in the economy at large and outside the Companies' control, the Companies should no longer absorb the money costs on these significant cash outlays. Accordingly, we will allow carrying charges to be recovered from customers on prepaid pension and PBOP balances.

The Attorney General argues that money costs on prepaid pension and PBOP balances are already being recovered in rates because of the 13.9 percent return on equity earned by the Companies in 2002 (Attorney General Brief at 14). We disagree. The Companies testified that the 13.9 percent return on equity, which serves as the basis for the Attorney General's conclusion, represented the return for the entire NSTAR business, both utility (i.e., regulated) and non-utility (i.e., unregulated), not for the utility business alone (Exh. AG-1, at 59; Tr. 1, at 15-16). Because there is no record evidence to substantiate that present rates provide for the recovery of carrying charges on prepaid (i.e., beyond what is compassed by rates) pension and PBOP balances, we decline to accept the Attorney General's position.

We next turn to the matter of the return on common equity. The Attorney General maintains that the Companies' return on equity should be lowered to recognize the reduced risk that results from the transfer of the volatility in pension and PBOP costs from the Companies to their ratepayers (Attorney General Brief at 10-11). According to the Attorney General, the authorized return on equity should be reduced from what the authorized return would be in the absence of the Companies' proposal (id. at 11).

We agree, in principle, with the Attorney General that the authorized return on equity includes a risk factor for the volatility in pension and PBOP costs. A regulated company that has assurance through a fully reconciling mechanism for the full recovery of expenses as volatile as pension and PBOP expenses is less risky than an utility without such a commitment. The Attorney General, however, has done nothing more than assert a point without proving it. He has not provided a basis by which to reduce the return on equity. He merely stated that the return on equity should be reduced by up to 50 basis points (Tr. 2, at 269-271, 276).

When the Department sets rates, it determines, as best it can, a representative level of includable and recoverable cost for many areas of business, based on test year experience but adjusted for known and measurable charges, whether up or down from test-year experience.

This exercise is premised on the proposition that test year experience needs to be adjusted to account not only for known and measurable changes but also to screen out the cost effects of extraordinary events (e.g., hurricanes, historically abnormal cold periods, etc.) that are unlikely to occur (or if they happened to occur during the test year, are, it is fair to suppose, unlikely to be repeated) and whose inclusion would pad rates to provide for costs that, ex hypothesi, are quite unlikely to be repeated during the time when new rates are to be in effect. The rate of return set by the Department implicitly assumes that while any element of recognized future costs may go up or down from year to year, all elements will likely vary within some fairly expectable range of normal business risk. But when a risk of perhaps unusually low probability, but of extraordinary magnitude is experienced and, in fact, materializes in actual harm or cost outside the normal range of variability assumed in rates and set returns, the reasonable expectation is that some relief may be warranted. Eastern/Colonial Acquisition, D.T.E. 98-128, at 56-57 (1999). In short, events of extraordinary magnitude but low probability are not incorporated or allowed for in ordinary rate case outcomes. Storms of devastating severity serve are a classic example, even though we know they are virtually certain to happen from time to time. Such, too, is the case with the effects of recent financial markets on the pension trusts and the way these effects can adversely translate into capital structure through SFAS 71, 87 and 106. We reject the Attorney General's proposal regarding the reduction to equity. There was no, and there customarily is no, recognition in allowed returns for the theoretically conceivable, but hardly likely, event or circumstance of extraordinary consequence. In short, when the highly extraordinary has happened before (even in a test year), it can, of course, happen again. But rates are set with an eye to customary expectations and are not set with the expectation that the highly extraordinary will (even though it may) occur again.

There is a cost of money associated with pension deferral and with prepaid pension amounts. The Department has authority in appropriate circumstances to allow carrying charges or amounts amortized. See, e.g., Attorney General v. Department of Public Utilities, 390 Mass. at 228, 231. The money tied up for this purpose is not fairly characterized as a short-term debt but must, consistent with the long-term-investment nature of workers' pensions and PBOP, come from the Companies' long-term capital. It is long-term capital that is financing these deferrals. The Companies' witness, Mr. Judge, presented testimony regarding the funds used for a pension prepayments as "financed with long-term capital." After a discussion of the Companies' short-term debt, he noted: pension prepayment is "a long-term asset; long-term capital has been assigned to it. It competes for the same exact dollars that we invest in our system. Instead of investing in substations and lines and poles, we have instead invested in our pension plan" (Tr. 1, at 80).

If this rate proceeding were a § 94 general rate case, which is after all the nearest comparable exercise, the Department would employ the weighted cost of capital that is applied to a petitioner-company's rate base and apply it to pension costs. The Department would do so because there really is no principled difference between the Companies' investment in rate base and their investment in pensions and PBOP. Both are long term investments and should be similarly treated. The Department also applies the weighted cost of capital to cash working capital, that long-term fund which must be set aside to draw on and then replenish for short-term needs. Like pension expenses, the demands on the cash-working capital fund may fluctuate; but the need for the fund or expense exists over the long-term and is treated accordingly.

As the instant docket is not a general rate case but bears some likeness to one, we can look to the record for any carrying cost numbers that may serve as reasonable proxies for the weighted cost of capital numbers the Department would compute in a rate case. There are two candidates on the record.

First, we have of record certain cost of money rates: the before-tax and after-tax rates in carrying charges that BECo, CELCo, and ComElectric, the three NSTAR electric distribution companies, presently accrue. The BECo rate was negotiated with the Attorney General for transition costs. The rates were set in D.P.U. 96-23 and D.P.U. 97-111. In addition, there is proposed to be averaged in with the electric companies the weighted cost of capital that Commonwealth Gas (now NSTAR Gas) settled on with the Attorney General in its last rate case, D.P.U. 91-60.

A second proxy candidate is the Companies' most recent known long-term debt financing (Tr. 1, at 69-70) of 4.875 percent. Boston Edison Company, D.T.E. 00-62 (2000); see also Commonwealth Electric Company, D.T.E. 02-51 (2002). This issuance is of more recent date than the three electric companies' restructuring and the gas company's 1991 settlement and has therefore a facial appeal as a surrogate or proxy for pension carrying charges. Although this long-term debt-issuance rate derives from relatively recent market conditions, it is significantly below the Companies' embedded cost for long-term debt and below what the Department typically establishes for return on equity. It is not representative of the Companies' weighted average cost of capital. Another drawback to using this long-term debt issuance rate as a proxy is that doing so in effect assigns or dedicates a discrete part of the Companies' capital structure to a particular investment (i.e., pension and PBOP cost), making it unavailable for rate base financing and rendering it excludable from any cost-of-capital amount applicable to rate base in future rate cases for the four companies. Such a highly particularized ascription is not something the Department typically does, and there is no compelling reason to do so where, as here, there are rates of record that can serve as useful and reasonable proxies, viz., the carrying cost numbers proposed by the Companies--especially after some judgment and modification are applied to them.

How do the carrying cost numbers proposed by the Companies compare to what the Department likely would determine in a rate case? Such a comparison for debt and equity provides a fair basis for judging the reasonableness of a proxy for a rate case outcome, we believe.[30] The after-tax carrying charge amounts proposed are not out of line with and are, in fact, rather comparable to embedded cost of debt numbers seen in recent and pending rate cases. See Berkshire Gas Company, D.T.E. 01-56, at 160 (2002) (8.63 percent); Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 294 (2002) (7.49%); Keyspan Energy Delivery System, D.T.E. 03-40 (company proposes 8.14 percent). These are comparable to

[30] See § VI.C.4.c, supra.

the debt costs in the three NSTAR electric distribution companies' transition charges: BECo, 8.31 percent; ComElectric, 8.82 percent; and CELCo, 8.92 percent.

As to the equity component of the proposed weighted cost of capital, we note that the Department recently set a return on equity of 10.5 percent for Berkshire and 10.00 percent for Fitchburg Gas and Electric Company. D.T.E. 01-56, at 118-119; D.T.E. 02-24/25, at 230. In the latter case, the rate was lower as a result of management considerations peculiar to that case. The return on equity in the transition cost carrying charges set for the three NSTAR electric companies is at or significantly below recent rate case experience: BECo, 7.99 percent; ComElectric, 10.80 percent; and CELCo, 9.90 percent. The proposed ComGas (NSTAR Gas) rate comes from its 1991 rate case. The economic conditions of twelve years ago that led to the NSTAR Gas outcome are now probably unrepresentative and outdated; and the Companies' proposal to average that figure into a weighted average cost of capital seems rather a reach. The NSTAR Gas figure should, accordingly, be excluded from our calculation.

Excluding NSTAR Gas and relying only on the figures for the three electric companies has the further recommendation that one of these three figures emerged from arm's-length negotiations with the Attorney General and was regarded as reasonably accurate and useful by BECo, by the Attorney General, and by the Department, which itself allowed it to take effect. The after-tax weighted average rate of just the three electric companies is 8.56 percent, which compares favorably with an after-tax weighted average rate of 9.04 percent for all four companies (i.e., when NSTAR Gas is included.)

While this 8.56 percent rate for pension and PBOP carrying charges would, we believe, be a not unreasonable or unrepresentative rate still, it can be improved upon to set a useable, interim rate for the reconciliation mechanism until the next rate case permits recalibration. The whole premise of the merger of BECo and ComEnergy was that melding ComEnergy's operating companies with the larger operations of BECo would lead to greater overall efficiency for all four companies. BECo is far and away the largest operation, with the greatest pension obligations of the four. BECo's after-tax rate is 8.16 percent or some 40 basis points below the weighted average of the three electric companies. Moreover, BECo's 8.16 percent after-tax rate has the clinching recommendation that is the only rate among the three companies to have emerged from negotiations with the Attorney General.

The Companies seek reasonable, but unusual relief from the effects of what are, after all, very unusual economic conditions and the unforeseen consequences those conditions lead to under FASB rules. Moreover, the relief sought is an opportunity to resolve the vexed question of pension expense recovery described supra in § III. In these circumstances, it is fair to limit the allowable carrying charge for all four NSTAR companies to BECo's after-tax rate of 8.16 percent. Accordingly, the Department finds and directs that in computing pension and PBOP costs for unamortized reconciliation balances, and prepaid amounts[31] consistent with the reconciling mechanism established by this Order, NSTAR shall use an after-tax carrying charge rate of 8.16 percent per annum for BECo, CELCo, ComElectric and NSTAR Gas

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[31] This continues until the balance of the prepaid contribution amount shall be reduced to zero.

(Exh. NSTAR-JJJ, at 34) or until that rate shall be re-set by the Department in future rate cases or other rate proceedings.[32] The Companies shall use the prime rate on their reconciliation of forecast recovery to actual recovery consistent with 220 C.M.R § 6.08(2).

If the Companies find this outcome unacceptable, they have an immediate remedy: they can file § 94 rate cases for any or for all four of the Companies. Doing so before their 10-K filing is due in early 2004 will also avert a write-down of equity in accordance with SFAS 71, as PwC's Mr. Spear has testified (Tr. 1, at 158). Similarly, the Attorney General has resort to § 93, if he wishes to pursue his over-earnings assertion. The Department has chosen the middle ground of establishing a forward-looking reconciliation mechanism to avoid the rate increase risks inherent in § 94 rate case.

5. Operation of Mechanism

The Department will allow the reconciling mechanism to operate in the following way. Commencing December 1, 2003, and continuing each succeeding year thereafter, the Companies will file a reconciliation of their SFAS-determined expenses for the prior calendar year, plus their previously unamortized balances,[33] with the amount included in rates ("Reconciliation Amount"). The Reconciliation Amount shall be amortized over three years. Further, carrying costs will be allowed on the average annual prepaid pension balance expense

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32 This does not change our precedent with respect to the ratemaking treatment of prepayments other than pensions.

33 During the years 2004-2006, the previously unamortized balance includes amounts allowed in D.P.U. 92-250 and D.P.U. 92-92.

and the unamortized deferred pension and PBOB expenses, net of deferred income taxes.[34] Commencing January 1, 2004, the Reconciliation Amount and carrying costs will be collected from, or refunded to, all customers on an equal cents per kilowatthour or therms basis over the following twelve months. The Reconciliation Amount and carrying costs shall be collected through the kilowatthour delivery charge for electric distribution companies and the Local Distribution Adjustment Factor for NSTAR Gas Company. The Companies shall apply the prime rate on their reconciliation of forecast recovery to actual recovery consistent with 220 C.M.R § 6.08(2).

V. ORDER

Accordingly, after due notice, hearing and consideration, it is

ORDERED: That the tariffs M.D.T.E. Nos. 109, 209, 309 and 406, filed with the Department on April 16, 2003 by Boston Edison Company, Commonwealth Electric Company, Cambridge Electric Light Company, and NSTAR Gas Company to become effective May 1, 2003 be and hereby are DISALLOWED; and it is

FURTHER ORDERED: That Boston Edison Company, Commonwealth Electric Company, Cambridge Electric Light Company, and NSTAR Gas Company shall file new tariffs, to become effective January 1, 2004, that are in compliance with this Order; and it is

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34 There will be no carrying costs on the deferred pension and PBOP expense recorded by the Companies during the first 8 months of 2003, as discussed in § VI.C.3 of this Order.

FURTHER ORDERED: That Boston Edison Company, Commonwealth Electric Company, Cambridge Electric Light Company, and NSTAR Gas Company shall follow all directives contained in this Order.

By Order of the Department,

__________________/s/____________
Paul G. Afonso, Chairman

__________________/s/__________
James Connelly, Commissioner

__________________/s/____________
W. Robert Keating, Commissioner

__________________/s/____________
Eugene J. Sullivan, Jr., Commissioner

__________________/s/____________
Deirdre K. Manning, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).